SMITH AFFILIATED CAPITAL

Investment Review

March 2023

When is the recession coming? Timing can be more valuable than Price.

It is a time-honored adage that monetary policy affects the economy with long and variable lags. Well, that time may be up if the tumult caused by the failure of a few regional banks is any indication. Markets saw increased volatility beginning March 9 as the recent bank run on Silicon Valley Bank and Signature Bank in New York forced the FDIC and the Federal Reserve to step in as a liquidity backstop for insured and uninsured depositors. The event sent shockwaves through the financial system and, at least for now, has changed the Fed's monetary policy guidance. The March 22 FOMC meeting took center stage amid a tumultuous environment raising the Fed funds rate by 25 basis points (bps) to 4.75-5.00%. The quarter-point rate hike was no surprise, although some thought the Fed should pause given the mounting stress in the banking system. While the Fed expects to continue hiking rates again to rein in inflation, investors expect just the opposite. The gap between where the Fed expects rates to be at year-end and what the futures market is pricing in is astonishingly wide.

World Markets	MTD (%)	YTD (%)	1Y (%)	10Y (%)	10Y STD (±)
DJIA	2.08	0.93	-1.98	11.12	14.97
S&P 500	3.67	7.48	-7.75	12.21	14.85
NASDAQ	6.78	17.05	-13.25	15.35	17.51
Equity EM Mkts.	3.04	3.97	-10.39	2.36	17.01
EM Bond Mkt.	1.24	2.15	-4.64	2.07	7.32
US Aggregate Bond	2.54	2.96	-4.78	1.36	4.30
Municipal Bond	2.22	2.78	0.26	2.38	4.63
US High Yield	1.13	3.68	-3.47	4.02	7.57
Commodity	-0.21	-5.36	-12.49	-1.71	14.13
COMEX Silver	14.72	0.68	-4.54	-1.95	27.89
COMEX Gold	7.57	7.98	0.73	2.07	14.62
Brent Oil	-4.41	-8.38	21.41	3.07	39.04
Dollar Index	-2.25	-0.98	4.27	2.14	6.52

Despite market uncertainty and volatility, the key question remains, when is the recession coming? There are two indicators we believe offer the best indication of economic growth. The first is The Conference Board's Index of Leading Economic Indicators (LEI). Their recent report showed the LEI for the US fell again by 0.3 percent in February 2023 to 110.0 (2016=100) after also declining by 0.3 percent in January, marking its eleventh consecutive monthly decline. The 12-month decline ending February of -6.5% is at a depressed level that typically precedes a recession. The Board stated that the most recent financial turmoil in the US banking sector is not reflected in the LEI data but could have a negative impact on the outlook if it persists. When might a recession occur? The Conference Board's report sees a 99% probability that the recession will start in early 2023 and last through the third quarter primarily due to the Federal Reserve's interest rate hikes. The first three quarters of 2023 will likely see zero or negative real GDP growth rates. The second indicator is the persistent inversion in the 10yr/2yr yield spread, combined with parabolic swings in the 2-year Treasury yields. An inversion followed by a sharp re-steepening (as we have seen over the last 2 weeks) should be cause for concern, as this tends to signal that a recession is imminent.

Equities overcame steep declines in the bank and financial stocks, with the tech-heavy NASDAQ providing a 6.78% return, driven mainly by rallies in Apple, Microsoft, NVIDIA, Tesla, and Netflix. Both the taxable and tax-exempt aggregate indices provided +2% returns. Silver outperformed Gold with a 14.72% return versus Gold's 7.57%. Conversely, oil and the US dollar were down, -4.41% and -2.25%, respectively.

Taxable Markets

Yields across the curve moved lower in March, reversing all of February's backup in rates settling close to the low yields seen in January. The most significant decline was in the 2-year treasury yield, down 79bps from February, 4.82% to 4.03%, returning 1.69% for March. With the rally, the curve became less inverted over the quarter, shifting from -90bps to -56bps. The more pronounced change was in longer durations where the 10/30 year slope of the curve has normalized once again to a positive spread after hitting -5bps in December and -10bps in February.

U.S. Fixed Income	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	% Rtn	Mo.	YTD	+/-	+/-
Aggregate Bond	2.26	0.28	2.54	2.96	6.33	4.40
US Treasury	2.69	0.20	2.89	3.01	6.28	3.83
US Agencies	1.71	0.21	1.92	2.09	3.23	4.33
Corporate	2.44	0.35	2.78	3.50	7.25	5.17
Non-Corp	2.20	0.27	2.47	3.12	6.04	4.46
Tax-Muni	1.51	0.45	1.96	4.71	9.60	4.91
US Agency MBS	1.61	0.34	1.95	2.53	5.93	4.51
Gov/Credit	2.56	0.26	2.82	3.17	6.55	4.34
TIPs	2.83	0.06	2.89	3.34	5.05	4.07
AAA Corporate	4.08	0.31	4.39	5.03	11.22	4.26
AA Corporate	3.18	0.30	3.49	3.95	8.61	4.48
A Corporate	2.35	0.33	2.68	3.31	7.05	4.98
BBB Corporate	2.37	0.38	2.74	3.57	7.14	5.45

The disruption in the banking sector resulted in some spread widening for investment-grade credits but is not surprising given the level of uncertainty and weaker economic data. On average, spreads widened mid-March to 165bps, with a tightening by month-end of 138bps. We expect corporate spreads to remain elevated and possibly widen more post-earnings season starting in April. We do not believe we will see the low spread of 115bps reached in February when the 10-

year treasury was 3.92%, for some time. Despite the widening in credit, the industrial sector provided the best return for the month and QTD, with long industrials producing the highest return of 4.8% MOM and 4.12% QTD. The financial sector had a net positive return for the month of 1.32%; given the disruption in regional banks, the banking sector as a whole held up well returning 1.25%. High quality, long duration significantly outperformed AAA corporates at 4.39% versus BBB corporates at 2.74%. Telecom, technology, and consumer staples were the best subcategories.

Although a welcome sign for fixed-income markets, we view the treasury rally as unsustainable in the short term and expect much of the banking challenges for regional financial institutions to be worked through over the next two quarters. The impact of the Fed rate hikes and the speed of the hikes will result in less issuance and less net supply in credit markets. We expect to see price dislocations across certain sectors as assets held by some of the banks may be liquidated by either regulators or bank CEOs as they reassess the duration of their deposits. Volatility will remain high as we move into earnings season in April, starting with First Republic on the 13th. March CPI inflation data and the BLS employment data will be released in the first two weeks of April. Given the data dependency of the Fed's rate decisions and recent banking events, economic weakness will be viewed as a positive for fixed-income markets. During this recent bond rally, the forward curve was pricing in at least 2-3 rate cuts of 25bps each over the next 12 months. Should the Fed stay with rate hikes, credit spreads will progressively widen, and the curve will resume the inversion with front-end rates higher. We remain neutral on duration across the credit sector with an overweight to higher quality industrials with stable fundamentals. We continue to hold a larger percentage of liquid assets in short-term bills and notes with a market weight to US treasuries, TIPs, and taxable municipals. Given the change in the curve slope, we favor intermediate to long durations in these sectors for 2Q23.

Tax-Exempt Markets

Municipals produced positive returns across the curve with intermediate to long durations with long maturities outperforming. Muni yields ended the quarter slightly above January's closing yield on the Aggregate index, 3.25% versus 3.10%. The Bloomberg Barclays Aggregate Muni Index is up, +2.1% for the month and +2.6% Year-to-Date. Part of the performance in recent weeks can be attributed to a pullback in supply that saw last month's issuance down 30% from a year ago. Since then, we have endured 9 FOMC rate hikes that had an impact on fund flows along the muni curve. Rates became so dislocated from the rapidity of the hikes that the 5s/1s AAA slope inverted to a -62bps in February, only to rally to a -27bps in March. Compounding the dramatic shifts in yields is the scarcity in supply which is expected to continue into the second quarter as state and local governments have slowed new issue borrowing given the higher interest rates. Creditsights data estimates total redemptions between April and June will be $74 billion against historical supply for the quarter that typically sees an average of $106 billion. If this trend continues, we will be left with a net negative supply scenario adding to price dislocations. April, in particular, due to tax filing, is expected to see half the month in flux as investors raise cash for tax bills.

On a relative 10-year basis, current muni yields for 5, 10, and 20-year bonds are 93bps, 36bps, and 58bps over the median level for the last 10 years.

We favor some duration and maturity extensions depending on the State. We continue to hold short-duration liquid investments for opportunities during periods of high volatility.

Municipal Market	Price	Cpn	Total Returns (%)		Dur	Yield
	(%) Rtn	(%) Rtn	Mo.	YTD	+/-	+/-
Municipal Agg	1.86	0.36	2.22	2.78	6.10	3.25
1-Yr Muni (1-2)	0.71	0.37	1.07	1.06	1.33	2.76
3-Yr Muni GO (2-4)	1.28	0.37	1.65	1.41	2.43	2.50
5-Yr. Muni GO (4-6)	1.68	0.36	2.04	2.02	3.62	2.42
7-Yr. Muni (6-8)	1.64	0.36	2.00	2.30	4.54	2.69
10-Yr. Muni (8-12)	1.75	0.35	2.10	2.76	5.30	2.76
15-Yr. Muni (12-17)	2.08	0.35	2.43	3.15	6.98	3.39
30-Yr. Muni (22+)	2.63	0.37	3.00	4.27	10.34	4.18
AAA Muni	1.88	0.35	2.23	2.50	5.96	2.93
AA Muni	1.86	0.36	2.22	2.65	6.01	3.06
A Muni	1.77	0.36	2.13	3.01	6.05	3.63
BBB Muni	2.10	0.37	2.47	3.71	7.60	4.36
Gen. Oblig.	1.95	0.35	2.30	2.59	5.72	2.94
State GO	1.85	0.36	2.21	2.50	4.85	2.75
Local GO	2.04	0.34	2.38	2.68	6.46	3.11
Revenue	1.87	0.36	2.23	2.96	6.49	3.43
California	1.83	0.35	2.18	2.55	6.04	3.07
New York	2.05	0.37	2.41	3.22	6.53	3.28

Precious Metals

Gold and Silver moved higher in March, with gold outperforming YTD, +7.57% versus Silver 0.68%. Contagion fears stemming from the financial stress, a weaker dollar, extreme positioning in US Treasuries, and the potential for a shift in Fed policy expectations saw the precious metals rally. Gold breached the $2000 level mid-month and closed at $1969 by month-end. Central banks' Gold buying marked a record year in 2022 as geopolitical risks climbed and markets repriced their holdings in local currencies on dollar weakness. If the banking sector continues to heal, we expect further unwinding of the recent bull-steepening decline in US rates, which will put downward pressure on Gold. So long as Gold remains above $1,945, the upside target of $2,050 remains in play. Given that the Price of Gold does not historically revisit its prior-year low, in this case, $1,627, we anticipate Gold prices to average $1809/oz in 2Q23 before another rally in 2H23.

Outlook

Before the banking sector shock, we expected fed funds to hit a terminal rate of 5.75% by July 2023, driven by a 25bp hike at the May, June, and potentially July FOMC meetings. However, with the recent liquidity events in the banking sector, the slowing in many Leading Indicators, and the continued inversion, we are lowering our terminal fed funds forecast by 50bps to 5.25%. This implies one more 25bp hike, which we expect at the May policy meeting but remains a relatively low-conviction call, with the risk that it could turn into a pause, depending on financial and credit developments in the interim.